

MANAGEMENT'S DISCUSSION AND ANALYSIS (MD&A)

The following is a discussion and analysis of the State of North Carolina's (the State's) financial performance, providing an overview of the activities for the fiscal year ended June 30, 2002. Please read it in conjunction with the transmittal letter at the front of this report and with the State's financial statements, which follow this section. Because fiscal year 2002 represents the first year in which the State implemented the provisions of Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, this discussion and analysis provides few comparisons with the previous year. Future reports are required to include extensive comparisons.

Highlights

Government-wide:

- The State's total net assets remained virtually unchanged as a result of this year's operations. While net assets of governmental activities increased by \$562 million, or nearly 2.6 percent, net assets of business-type activities decreased by \$509 million, or about 36.5 percent. At year-end, net assets of governmental activities and business-type activities totaled \$22.015 billion and \$886 million, respectively.
- Component units reported net assets of \$8.2 billion, an increase of \$362.1 million from the previous year. The largest component unit, the University of North Carolina System had net assets of \$5.79 billion at June 30, 2002, an increase of \$178 million, or a 3.2% increase from fiscal year 2001.

Fund Level:

- As of the close of the fiscal year, the State's General Fund reported a total fund balance deficit of \$349 million, with reserves of \$227.8 million, and an unreserved fund balance of negative \$576.3 million.
- The business-type activities funds reported net assets at year-end of \$886 million during the year.

State Highway System:

- The State highway system includes roadway surfaces, bridges, signage, railings, markings and other structures related to the State's motor vehicle transportation system. The system includes 78,350 miles of roads, constituting the second largest highway system in the nation. The system includes 17,250 bridges spanning 380 miles.
- For fiscal year 2002, the State reflected \$11.5 billion (net of accumulated depreciation) of highway system infrastructure, an increase of \$917 million (net), or 8.6%.

Long-term Debt:

- The State's general obligation debt payable increased during the fiscal year to \$3.478 billion, an increase of \$439 million (or by 14.5%), which represents the net difference between new issuances, and payments, recognition of accretion, and the amortization of premiums on outstanding debt.
- During the year the State issued general obligation bonds in the amount of \$605 million. More detailed information regarding these activities and funds begins on page 85.

OVERVIEW OF THE FINANCIAL STATEMENTS

This discussion and analysis is an introduction to the State's basic financial statements, which comprise three components: 1) government-wide financial statements, 2) fund financial statements, and 3) notes to the financial statements. This report also contains additional required supplementary information (*General Fund budgetary schedules, pension funding progress and contributions*) and other supplementary information (combining financial statements) in addition to the basic financial statements. These components are described below.

Government-wide Financial Statements

The Statement of Net Assets and the Statement of Activities are two financial statements that report information about the State, as a whole, and about its activities that should help answer this question: Is

the State, as a whole, better off or worse off as a result of this year's activities? These statements include all non-fiduciary assets and liabilities using the accrual basis of accounting. The current year's revenues and expenses are taken into account regardless of when cash is received or paid. The Statement of Net Assets (page 46) presents all of the State's assets and liabilities, with the difference between the two reported as "net assets". Over time, increases and decreases in net assets measure whether the State's financial position is improving or deteriorating.

The Statement of Activities (pages 48 and 49) presents information showing how the State's net assets changed during the most recent fiscal year. All changes in net assets are reported as soon as the underlying events giving rise to the change occur, regardless of the timing of related cash flows. Therefore, revenues and expenses are reported in these statements for some items that will only result in cash flows in future fiscal periods (e.g. uncollected taxes and earned but unused vacation leave).

Both statements report three activities:

Governmental Activities – Most of the State's basic services are reported under this category. Taxes and intergovernmental revenues generally fund these services.

Business-type Activities – The State charges fees to customers to help it cover all or most of the cost of certain services it provides. The State's Unemployment Compensation Fund is the predominant business-type activity.

Discretely Presented Component Units – Component units are legally separate organizations for which the elected officials of the primary government are financially accountable. A description of the component units and an address for obtaining their separately issued financial statements can be found beginning on page 64. All component units are combined and displayed in a separate discrete column in the government-wide financial statements to emphasize their legal separateness from the State. In addition, condensed financial statements for major component units are presented in the notes to the financial statements (page 119).

This report includes two schedules (pages 53 and 55) that reconcile the amounts reported on the governmental fund financial statements (modified accrual accounting) with governmental activities (accrual accounting) on the appropriate government-wide statements. The following summarizes the impact of transitioning from modified accrual to accrual accounting:

- Capital assets used in governmental activities are not reported on governmental fund statements.
- Certain tax revenues that are earned, but not available, are reported as governmental activities, but are reported as deferred revenue on the governmental fund statements.
- Other long-term assets that are not available to pay for current period expenditures are deferred in governmental fund statements, but not deferred on the government-wide statements.
- Internal service funds are reported as governmental activities, but reported as proprietary funds in the fund financial statements.
- Certain pension trust funds have been funded in excess of their annual required contribution. These assets are recorded only in the government-wide statements.
- Unless due and payable, long-term liabilities, such as capital lease obligations, compensated absences, litigation, bonds and notes payable, and others only appear as liabilities in the government-wide statements.
- Capital outlay spending results in capital assets on the government-wide statements, but are reported as expenditures on the governmental fund statements.
- Bond and note proceeds result in liabilities on the government-wide statements, but are recorded as other financing sources on the governmental fund statements.
- Certain other outflows represent either increases or decreases in liabilities on the government-wide statements, but are reported as expenditures on the governmental fund statements.

The Notes to the Financial Statements provide additional information that is essential to a full understanding of the data provided in the government-wide and fund financial statements. The notes can be found beginning on page 64 of this report.

Fund Financial Statements

The fund financial statements begin on page 52 and provide detailed information about the major individual funds. A fund is a fiscal and accounting entity with a self-balancing set of accounts that the State uses to keep track of specific sources of funding and spending for a particular purpose. In addition to the major funds, page 137 begins the individual fund data for the non-major funds. The State's funds are divided into three categories – governmental, proprietary, and fiduciary – and use different accounting approaches.

Governmental funds -- Most of the State's basic services are reported in the governmental funds, which focus on how money flows into and out of those funds and the balances left at year-end that are available for future spending. The governmental fund financial statements provide a detailed short-term view of the State's general government operations and the basic services it provides. Governmental fund information helps determine whether there are more or fewer financial resources that can be spent in the near future to finance the State's programs. These funds are reported using *modified accrual* accounting, which measures cash and all other financial assets that can readily be converted to cash. Governmental funds include the General Fund and special revenue, capital project, and permanent funds.

Proprietary funds -- When the State charges customers for the services it provides, whether to outside customers or to other agencies within the State, these services are generally reported in proprietary funds. Proprietary funds (enterprise and internal service) utilize accrual accounting; the same method used by private sector businesses. Enterprise funds report activities that provide supplies and services to the general public. The Unemployment Compensation Fund is our most significant enterprise fund. Internal service funds report activities that provide supplies and services for the State's other programs and activities - such as the State's State Property Fire Insurance Fund, the Motor Fleet Management Fund, Centralized Computing Services Fund, and Telecommunications Services Fund. Internal service funds are reported as governmental activities on the government-wide statements.

Fiduciary funds -- The State acts as a trustee or fiduciary, for its employee pension plans. It is also responsible for other assets that, because of a trust arrangement, can be used only for the trust beneficiaries. The State's fiduciary activities are reported in separate Statements of Fiduciary Net Assets and Changes in Fiduciary Net Assets beginning on page 60. These funds, which include pension (and other employee benefits), private-purpose, investment trust, and agency funds, are reported using accrual accounting. The government-wide statements exclude fiduciary fund activities and balances because these assets are restricted in purpose and cannot be used to support the State's own programs.

Additional Required Supplementary Information

Following the basic financial statements and note disclosures is additional Required Supplementary Information that further explains and supports the information in the financial statements. The Required Supplementary Information includes General Fund budgetary comparison schedules reconciling the statutory and generally accepted account principles (GAAP) fund balances at fiscal year-end, and pension plan trend information related to funding progress and contributions.

Supplementary Information

Supplementary information includes the introductory section, and the combining financial statements for non-major governmental, proprietary, and fiduciary funds. These funds are added together, by fund type, and presented in single columns in the basic financial statements, but are not reported individually, as with major funds, on the governmental fund financial statements.

FINANCIAL ANALYSIS OF THE GOVERNMENT AS A WHOLE

Statement of Net Assets. The State's combined net assets increased \$68.3 million, or .3% over the course of this fiscal year's operations. The net assets of the governmental activities increased \$577.7 million or 2.7% and business-type activities had a decrease of \$509.4 million or 36.5%.

Net Assets as of June 30, 2002
(In Millions)

	Governmental Activities	Business-type Activities	Total Primary Government
Current and other non-current assets.....	\$ 10,312	\$ 1,142	\$ 11,454
Capital assets, net.....	22,340	42	22,382
Total assets.....	32,652	1,184	33,836
Long-term liabilities.....	3,711	10	3,721
Other liabilities.....	6,926	288	7,214
Total liabilities.....	10,637	298	10,935
Net assets:			
Invested in capital assets, net of related debt.....	22,025	38	22,063
Restricted.....	1,605	798	2,403
Unrestricted.....	(1,615)	50	(1,565)
Total net assets.....	\$ 22,015	\$ 886	\$ 22,901

The largest component (98%) of the State's net assets reflects its investment in capital assets (land, buildings, machinery and equipment, State highway systems, general infrastructure, and other capital assets), less any related debt outstanding that was needed to acquire or construct the assets. In subsequent years, comparative data will provide the basis for more detailed analysis.

The State of North Carolina, like many other state and local governments, issues general obligation debt and distributes the proceeds to local governments and component units. The proceeds are used to expand university and community college capacity, fund capital maintenance, build local schools, and to provide local access to clean water and natural gas utilities. Of the \$3.48 billion of outstanding general obligation debt at June 30, 2002, \$3.17 billion of the outstanding debt is attributable to debt issued as State aid to component units (universities and community colleges) and local governments. The balance sheets of component unit and local government recipients reflect ownership of the related constructed capital assets without the burden of recording the debt obligation. The policy of selling general obligation bonds and funneling the cash proceeds to non-primary government (non-State) entities has been in place for decades. Through this policy the State was able to promote improved financial management, save bond issuance costs, and receive more attractive financing arrangements. However, by issuing debt and sending the cash proceeds outside of the State, the State is left to reflect significant liabilities on its statement of net assets (balance sheet) which are reflected in the unrestricted net asset component since there are no offsetting capital assets.

The government-wide statement of net assets for governmental activities reflects a negative \$1.6 billion unrestricted net asset balance, with total net assets of \$22.015 billion, and capital assets, net of related debt of \$22.025 billion. Total restricted governmental assets for fiscal year 2002 was \$1.6 billion. From the governmental activities perspective, the fiscal year 2002 statement of net assets indicates that the State is over-committed by \$1.6 billion, primarily because of the distribution of debt proceeds mentioned previously and other unfunded liabilities.

Statement of Activities. The following condensed financial information was derived from the government-wide Statement of Activities and reflects how the State's net assets changed during the fiscal year:

Changes in Net Assets
For the Fiscal Year Ended June 30, 2002
(In Millions)

	Governmental Activities	Business-type Activities	Total Primary Government
Revenues			
Program revenues			
Charges for services.....	\$ 1,313	\$ 461	\$ 1,774
Operating grants and contributions.....	8,787	439	9,226
Capital grants and contributions.....	714	1	715
General revenues			
Taxes			
Individual income tax.....	7,235	—	7,235
Corporate income tax.....	599	—	599
Sales and use tax.....	3,779	—	3,779
Gasoline tax.....	1,213	—	1,213
Franchise tax.....	591	—	591
Highway use tax.....	555	—	555
Insurance tax.....	348	—	348
Beverage tax.....	201	—	201
Inheritance tax.....	107	—	107
Other taxes.....	279	—	279
Tobacco settlement.....	176	—	176
Unrestricted investment earnings.....	139	—	139
Miscellaneous.....	57	—	57
Total revenues.....	26,093	901	26,994
Expenses			
General government.....	874	—	874
Primary and secondary education.....	6,803	—	6,803
Higher education.....	2,520	—	2,520
Health and human services.....	10,377	—	10,377
Economic development.....	469	—	469
Environment and natural resources.....	627	—	627
Public safety, corrections and regulation.....	2,109	—	2,109
Transportation.....	1,531	—	1,531
Agriculture.....	122	—	122
Interest on long-term debt.....	149	—	149
Unemployment compensation.....	—	1,337	1,337
Other business-type activities.....	—	25	25
Total expenses.....	25,581	1,362	26,943
 Excess (deficiency) before contributions and transfers.....	 512	 (461)	 51
 Contributions to permanent funds.....	 2	 —	 2
Transfers.....	48	(48)	—
Increase (decrease) in net assets.....	562	(509)	53
Net assets - beginning - restated.....	21,453	1,395	22,848
Net assets - ending.....	\$ 22,015	\$ 886	\$ 22,901

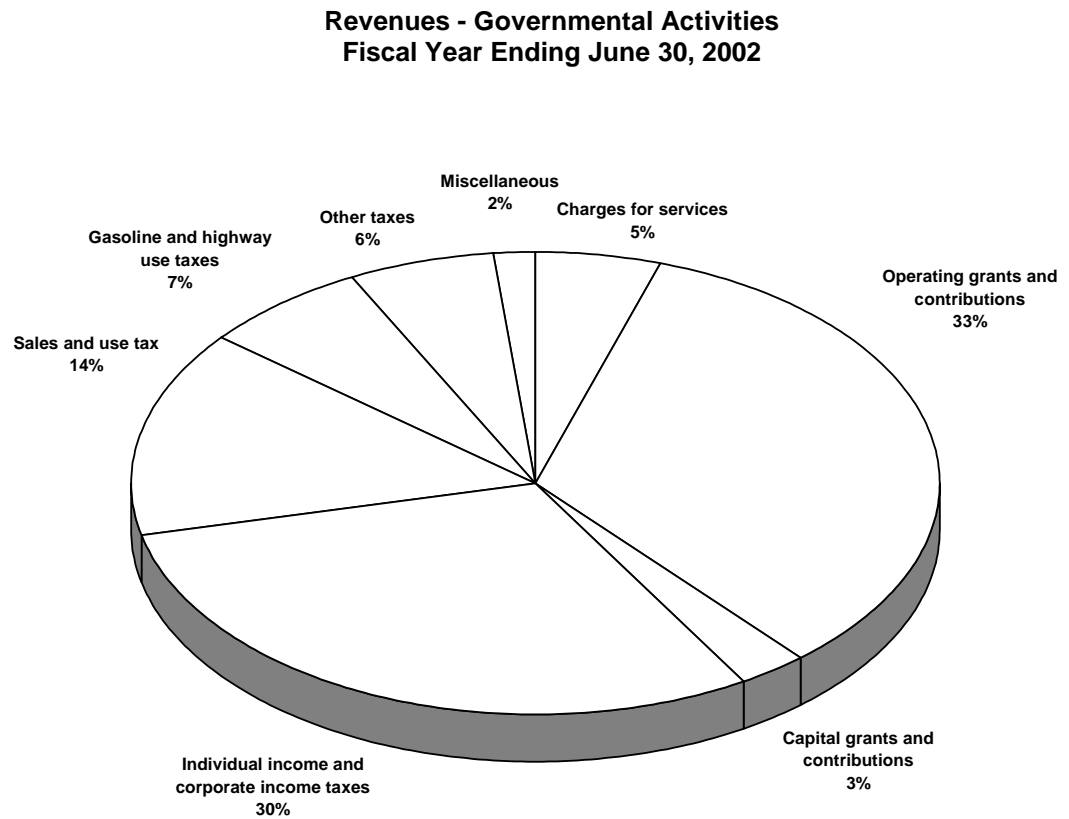
As a result of this year's operations, the net assets of governmental activities increased by \$562 million, or 2.6%. While this indicates that current year revenues were sufficient to cover current year expenses, the growth in net assets was limited by the slowdown in the State's economy and the associated increased demand for government services.

The State highway system is estimated to have a public service life of 50 years based on the planned maintenance schedule. Therefore, instead of charging the entire cost of additions to expense for the State highway system in the year of construction, the State highway system is capitalized and depreciated (costs allocated) over the estimated life of the highway system. The expenses are allocated over the periods of service to the public.

Business-type activities reflect a decrease in net assets of \$509 million. The Unemployment Compensation Fund is the predominant activity accounting for 89.5% of the total net assets of the business type activities. Please refer to the discussion of major funds for more information on the Unemployment Compensation Fund.

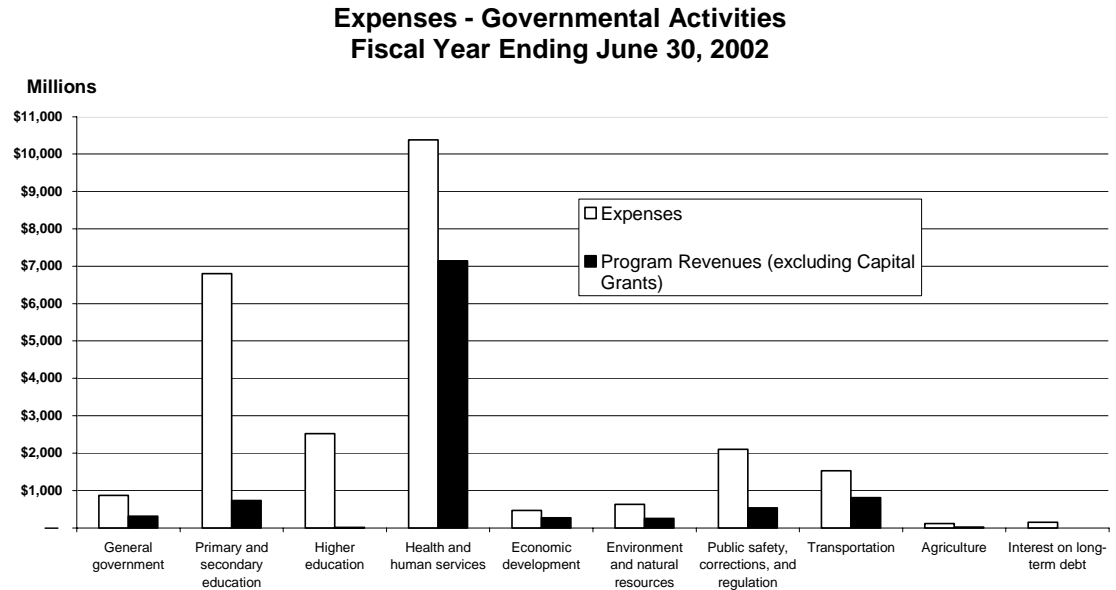
Governmental Activities:

The following chart depicts revenues of the governmental activities for the fiscal year:



The State sales tax was increased by a half-cent from 4% to 4.5%, effective October 16, 2001. This increase is scheduled to expire July 1, 2003. Effective July 1, 2002, the provisions for local government tax reimbursements were repealed, and local governments now have the optional authority to impose an additional half-cent sales tax. Effective for the tax years January 1, 2001 through December 31, 2003, the highest individual income tax rate increased from 7.75% to 8.25%.

The following chart depicts expenses of the governmental activities for the fiscal year:



Business-type Activities

Net assets of the business-type activities decreased by \$509.4 million during the fiscal year. The primary factor contributing to these results included:

- Due to the increasing unemployment in the State (due to the slowing economy and losses or lower profits for business in North Carolina), the North Carolina Unemployment Compensation Funds' payment of benefits increased from \$678 million in fiscal year 2001 to \$1.3 billion during fiscal year 2002. However the negative impact on net assets was only \$515 million, because of increases in operating revenues during the year. Operating revenues increased by \$412.8 million, or 104%.

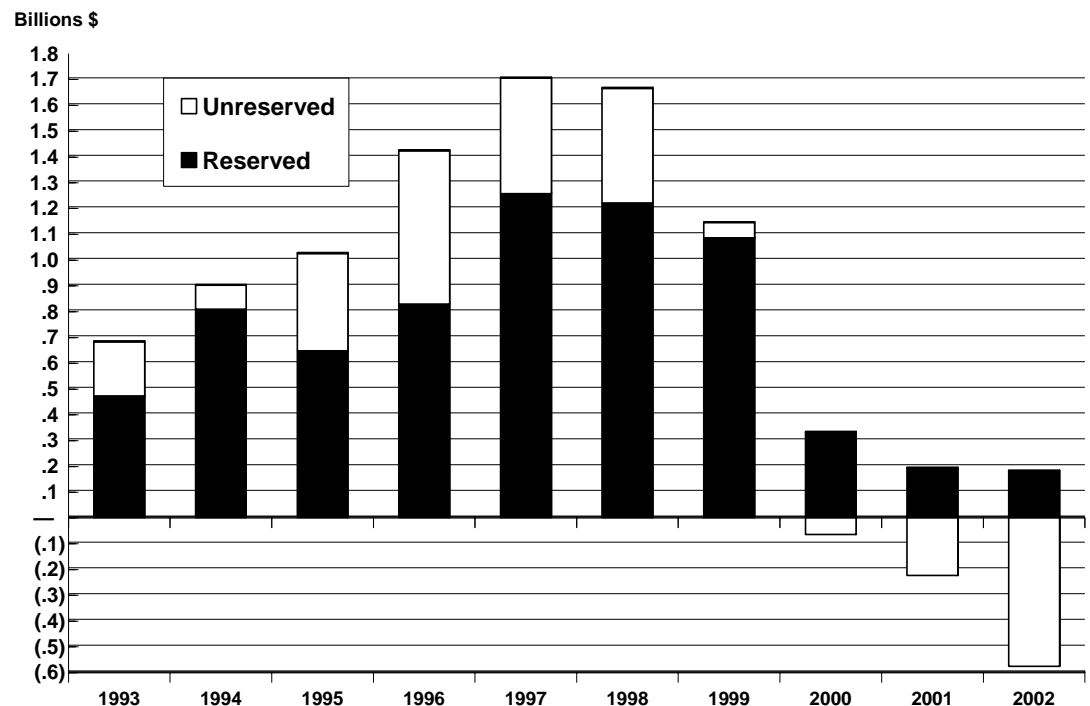
FINANCIAL ANALYSIS OF THE STATE'S INDIVIDUAL FUNDS

As the State completed the year, the governmental funds reflected fund balances of \$3.08 billion. This represented a decline in fund balances of \$513.5 million in fiscal year 2002. The General Fund decline of \$319.5 million, and the Highway Trust Fund decline of \$274.6 million represent the largest portion of the overall decrease in governmental funds.

General Fund

The General Fund is the chief operating fund of the State. At the end of fiscal year 2002, the State's General Fund reported a total fund balance deficit (negative) of \$349 million, with unreserved fund balance of negative \$576.3 million and reserved fund balance of \$227.8 million. With the addition of management designations as described in Note 8, the State's General Fund was over-committed by \$1.1 billion at June 30, 2002. Total fund balance diminished significantly during the fiscal year (\$319.5 million), primarily the result of lower tax collections and the general slowing of the economy. The public's demand for government services tends to grow or remain strong during times of economic difficulty, particularly in relation to the primary functions funded by General Fund operations (education, health and human services). By the end of fiscal year 2002, General Fund revenues had declined .21% from the prior year. On a modified accrual basis, individual income tax decreased by \$385.7 million, or 5%. Corporate income tax decreased by \$164 million, or 23%. Franchise tax revenues decreased by \$154.4 million, or 20.7%. Sales and use tax increased by \$336.8 million, or 9.8%, although the rate of increase was less than expected given the half-cent rate increase effective for fiscal year 2002. Despite the decline in revenues, General Fund expenditures increased by 366.4 million, or 1.7%.

FUND BALANCES OF THE GENERAL FUND (GAAP Basis)



General Fund Budgetary Highlights

Original versus Final Budget. The General Fund is the State's only major fund, as defined by GASB Statement No. 34, to have a legally adopted annual budget. The original and final annual budgets include budget appropriations supported by tax, non-tax, and other departmental receipts. The portion of the original budget comprising departmental receipts is not intended to be a controlling point in the effort to manage the State's General Fund budget. The final budget includes amendments for departmental receipts collected during the fiscal year. General Fund departmental receipts are typically

authorized for expenditure within the activity that generated the receipt. Historically, final estimated receipts have varied significantly from the original estimate at the beginning of the fiscal year. State agencies expend departmental receipts prior to spending State tax and non-tax supported appropriations. If departmental receipts are higher than expected, appropriated dollars may go unspent and be re-appropriated in a subsequent fiscal year.

Final Budget versus Actual Experience. The *Schedule of Revenues, Expenditures and Changes in Unreserved Fund Balance—Budget and Actual (Budgetary Basis—Non-GAAP)*, General Fund is intended to demonstrate legal compliance. In a typical year of General Fund budgetary operations, federal and intra-governmental transactions will be significantly under-realized with an offsetting under-expenditure in the primary and secondary education; health and human services; and public safety, corrections, and regulation. When departmental receipts reflect under-realized revenues, there is an offsetting under-expenditure of dollars against total budgeted appropriations.

For fiscal year 2002, the State experienced a shortfall in tax and non-tax receipts on the order of \$1.55 billion. Typical with the experience of other state governments, the slowing national and state economy, resulted in a general decline in tax collections. Net of refunds to taxpayers, individual income taxes fell short of estimates by \$1.04 billion, corporate income taxes were less than expected by \$177 million, sales and use tax was \$90.5 million less than expected, and franchise tax was \$192.7 million under budget estimates. Inheritance tax collections fell short of estimates by \$25.4 million. Higher unemployment, lower individual business and corporate earnings, and a declining stock market, resulting in lower capital gains, represented the common thread in the general tax revenue decline.

In the effort to meet the State constitutional mandate of balancing the General Fund budget, reductions of \$789.2 million were implemented, with the remainder of the budget funded by \$437.7 million of non-General Fund dollars, and \$239.3 million transferred from the Savings Reserve account.

Budget reductions affecting the major General Fund functions of our State government were as follows: general government, 9.9%; primary and secondary education, 1.8%; community colleges, 7.1%; public universities, 8.6%; health and human services, 3.9%; economic development, 12.9%; environment and natural resources, 18.9%, public safety, correction, and regulation, 4.5%; and agriculture, 12.5%.

Investment income fell short of estimated budgetary receipts by \$34.2 million as a result of lower General Fund cash available for investment and lower investment rates of return.

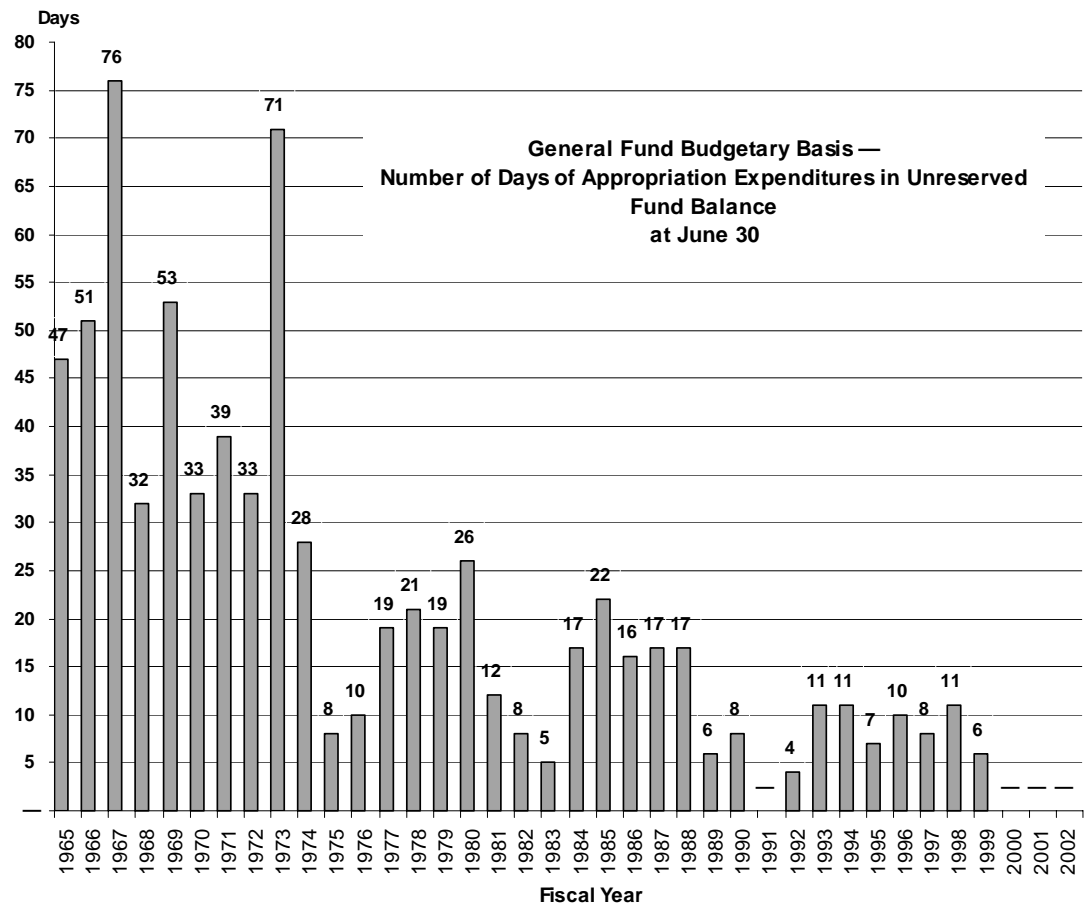
Our State manages the budget through the Office of State Budget and Management (OSBM). For fiscal year 2002, OSBM executed the necessary cuts in the budget by withholding portions of quarterly allotments and by giving agencies targeted reductions in spending. The final budget for tax and non-tax revenues is never amended without a special session of the General Assembly. The appropriation of increases in departmental receipts is authorized by the General Assembly through special provision in the biennial budget bill.

Each state has flexibility in how it decides to establish and execute its budget. For example, North Carolina nets certain distributions of State funds to local governments and other entities directly out of taxes, where other states may appropriate similar activities. Effective for fiscal year 2003, certain local government distributions previously considered continuing State appropriations from State revenue collections, will be accounted for and reported as local government funds.

Refunds to individual income taxpayers of \$1.373 billion represented 15.9% of total gross individual income collections for fiscal year 2002. Refunds to corporate taxpayers of \$230.8 million represented 23.2% of gross corporate income tax collections. Refunds of sales and use tax totaled \$398.7 million in fiscal year 2002, or 6.8% of gross collections.

For fiscal year 2002, the General Fund again closed the year with an extremely low unreserved fund balance. For the fiscal years ended June 30, 2000, 2001, and 2002, the ending unreserved fund balance was zero, zero, and \$3.8 million, respectively. To gain a sense of perspective, since 1965 unreserved

fund balance in the General Fund averaged \$200 million per year, or 3.9% of total appropriation expenditures, equivalent to 10 business days disbursements of appropriation expenditures. In the decade of the 1990's, unreserved fund balance averaged \$293 million, or 3.1% of appropriation expenditures, equivalent to eight business days worth of disbursements of appropriation expenditures.



North Carolina is required by its constitution to balance the General Fund on a budgetary basis. The budgetary basis reserved fund balance totaled \$390.1 million (see table below). See the notes to required supplemental information for a more detailed discussion of our State's budgetary process. The following schedule summarizes current year changes in the budgetary reserve accounts. Amounts are expressed in thousands.

General Fund Reserved Fund Balance	Balance June 30, 2001	Increases		(Decreases)		Balance June 30, 2002
		Transfers from General Fund Unreserved Fund Balance	Unbudgeted Revenues	Transfers to General Fund Unreserved Fund Balance	Unbudgeted Expenditures	
Savings.....	\$ 157,522	\$ 90,000	\$ 7,352	\$ (239,342)	\$ (15,532)	\$ —
Retirees' health premium...	53,895	—	—	—	(3,085)	50,810
N.C. Railroad acquisition...	31,582	—	—	—	(9,501)	22,081
Disproportionate share.....	1,170	—	—	—	(1,170)	—
Disaster relief.....	448,608	—	123,583	—	(254,956)	317,235
Exec. Order #3.....	178,472	2,911	—	—	(181,383)	—
Exec. Order #19.....	—	—	440,915	(324,915)	(116,000)	—
Total.....	\$ 871,249	\$ 92,911	\$ 571,850	\$ (564,257)	\$ (581,627)	\$ 390,126

General Fund Fiscal Year 2003 Budget. The General Fund State appropriations budget for fiscal year 2003 is \$14.35 billion. The General Assembly took action on several revenue enhancements for fiscal year 2003, totaling \$866.1 million. The most significant action was the accelerated repeal of the local government reimbursements paid to replace revenues lost by local governments as the result of actions taken by the State (\$333.4 million for fiscal year 2003). Local governments were granted the authority to establish a one-half cent local option sales tax to replace the reimbursements. Additionally, the annual transfer from the Highway Trust Fund was increased by \$205 million for 2002-2003, of which \$80 million is to be on a recurring basis, with \$125 million established a one-time advance to be repaid in the future. Additional non-recurring transfers of \$38 million, from the Tobacco Trust Fund, and \$40 million, from the Health and Wellness Trust Fund were approved by the General Assembly for fiscal year 2003. The following table summarizes the fiscal year 2003 revenue enhancements. Amounts are expressed in millions.

	Amount
Local government reimbursements cancelled	\$ 333.4
Highway Trust Fund Transfer — advance	125.0
Business tax revisions	90.0
Highway Trust Fund Transfer — recurring adjustment	80.0
Delay 2001 tax breaks	51.7
Transfer from Health and Wellness Trust Fund — non-recurring	40.0
Departmental fee increases	39.3
Transfer from Tobacco Trust Fund — non-recurring	38.0
Department of Revenue — Project Collect Tax	32.5
Special Fund / Trust Fund Transfers — non-recurring	20.4
Internal Revenue Code Conformity	15.8
Total	\$ 866.1

Highway Fund

The Highway Fund accounts for most of the activities of the North Carolina Department of Transportation, including the construction and maintenance of the State primary, secondary, and urban road systems. The principal revenues of the Highway Fund are gasoline (motor fuels) taxes, motor vehicle registration fees, driver's license fees, and federal aid.

While the effects of the slowing economy have had an impact on business travel, commercial transportation and general consumer travel and tourism, the States highway fund taxes and fees have still shown growth. Although total revenue of the Highway Fund declined by \$29 million, or 1.3%, gasoline tax increased by \$20 million, or 2.3%, and fees, licenses, and fines increased by \$18.8 million, or 4.8%. The largest decrease came in the decline of accrued federal funds, \$52 million, or 5.8%. Expenditures for highway construction, maintenance, and administration grew by \$103 million, or 4.5%.

Highway Trust Fund

The Highway Trust Fund was established to provide a dedicated funding mechanism to meet highway construction needs for North Carolina. Taxes were increased for the specific purpose of improving identified primary transportation corridors within the State and for the completion of urban loops around seven major metropolitan areas. Additionally, this fund provides supplemental allocations for secondary road construction and supplemental assistance to municipalities for local street projects. The fund also makes transfers to the General Fund and the Highway Fund. The principal revenues of the Highway Trust Fund are highway use taxes, motor fuels taxes, and various title and registration fees.

Total revenues of the Highway Trust Fund declined by \$10.8 million, or 1%. The decline in investment and interest earnings of \$26.7 million, as a result of lower cash balances to invest, had the largest impact on the Highway Trust Fund. Gasoline tax increased by \$8.3 million, or 2.9%, and highway use tax grew by \$9 million, or 1.7%. Transportation related expenditures of the Highway Trust Fund grew by \$63.5 million, or 11.9%.

Unemployment Compensation Fund

The Unemployment Compensation Fund accounts for the State's unemployment insurance program, which is part of a national system established to provide temporary benefit payments to eligible unemployed workers. The unemployment benefits are financed primarily by State unemployment insurance taxes, distributions of federal unemployment insurance taxes, and federal funding for the unemployment benefits.

For fiscal year 2002, employer contributions grew by \$52.5 million, or 13.8%. Federal Funds grew by \$361.3 million, or 2,465%. The drastic growth in revenues was driven by a slowing economy and an increasing unemployment rate in North Carolina. Unemployment benefits paid in fiscal year 2002 totaled \$1.3 billion, a 96.6% increase in payments over fiscal year 2001. Net assets of \$793 million at June 30, 2002 represented a decline of \$516.2 million, or 39.4%.

CAPITAL ASSETS AND DEBT ADMINISTRATION

Capital Assets: At the end of the fiscal year 2002, the Statement of Net Assets reflected \$22.382 billion, net of accumulated depreciation, in a broad range of capital assets (see the table below). Depreciation charges for this fiscal year totaled \$515.7 million.

Capital Assets, Net as of June 30, 2002
(In Millions)

	Governmental Activities	Business-type Activities	Total Primary Government
Land.....	\$ 7,209	\$ 3	\$ 7,212
Buildings.....	1,330	15	1,345
Machinery and equipment.....	576	1	577
General infrastructure.....	88	7	95
State highway system.....	11,547	—	11,547
Other.....	135	—	135
Subtotal.....	20,885	26	20,911
Construction in progress.....	1,455	16	1,471
Total.....	\$ 22,340	\$ 42	\$ 22,382

The effort to manage the State's General Fund budget shortfall resulted in the postponement of most construction and maintenance activity. The State's fiscal year 2001-2002 capital outlay budget included spending \$32.9 million for new projects at various state agency buildings. More detailed information about the State's capital assets is presented in Note 4 to the financial statements, and in Note 17.

For fiscal year 2002, the State reflected \$11.5 billion (net of accumulated depreciation) of highway system infrastructure, an increase of \$917 million (net), or 8.6%. Depreciation expense for the highway system was \$315 million for fiscal year 2002. Based on the requirements of GASB Statement No. 34, governments were only required to capitalize major infrastructure systems back to July 1, 1980. The North Carolina Department of Transportation was able to recall and capitalize construction expenditure information to include highway system construction costs since 1953.

Long-term Debt: The State authorizes, issues, and sells debt obligations. General obligation bonds, issued by the State, are backed by the full faith and credit of the State. The State also issues revenue dedicated bonded debt, whose payment for principal and interest comes solely out of funds that receive legally restricted revenues. More detailed information regarding the State's long-term obligations is presented in Note 6 to the financial statements.

Outstanding Bonded Debt as of June 30, 2002
(In Millions)

	<u>Governmental Activities</u>	<u>Business-type Activities</u>	<u>Total Primary Government</u>
General obligation bonds (backed by the state).....	\$ 3,478	\$ —	\$ 3,478
Revenue bonds and notes (backed by specific tax and fee revenues).....	<u>—</u>	<u>10</u>	<u>10</u>
Total	<u><u>\$ 3,478</u></u>	<u><u>\$ 10</u></u>	<u><u>\$ 3,488</u></u>

During fiscal year 2002, the State issued general obligation debt totaling \$605 million (\$300 million for capital maintenance and expanding the capacity of universities and community colleges; \$215 million for clean water; \$55 million for local school construction; and \$35 million for natural gas).

The State is in the process (\$300 million referred to above issued in fiscal year 2002) of fulfilling a significant commitment to increase the capacity of the universities and community colleges and to provide funding for renovations. In November 2000, the State's voters approved \$3.1 billion of University and Community College general obligation bonds. The General Assembly has predetermined the specific building projects to be funded by the bond proceeds. At June 30, 2002, there was a remaining bond authorization of \$2.55 billion of higher education bonds yet to be issued, constituting 82.3% of the original \$3.1 billion higher education bond authorization.

Bond Ratings

The State's general obligation bonds are rated Aa1 by Moody's, AAA by Standard & Poors, and AAA by Fitch. During the fiscal year, Moody's Investors Services downgraded the State of North Carolina's general obligation rating to Aa1, from Aaa. According to Moody's, the primary reasons for the downgrade were the State's continued budget pressure, reliance on non-recurring revenues, and weakened balance sheet. Also, Moody's commented that the task of restoring structural budget balance and rebuilding reserves faces political and economic obstacles.

Limitations on Debt

The limitations on the increase of State debt are contained in the State Constitution, Article 5, Section 3. This section restricts the General Assembly from contracting debts secured by a pledge of the faith and credit of the State, unless approved by a majority of the qualified voters of the State except for:

1. To fund or refund a valid existing debt;
2. To supply an unforeseen deficiency in the revenue;
3. To borrow in anticipation of the collection of taxes due and payable within the current fiscal year to an amount not exceeding 50 percent of such taxes;
4. To suppress riots or insurrections, or to repel invasions;
5. To meet emergencies immediately threatening the public health or safety, as conclusively determined in writing by the Governor;
6. For any other lawful purposes, to the extent of two-thirds of the amount by which the State's outstanding indebtedness shall have been reduced during the next preceding biennium.

No short-term borrowing occurred in fiscal year 2002.

ECONOMIC CONDITION AND OUTLOOK

The unemployment rate has dropped from 6.9% in April to 6.0% in October, and we have seen improvement in the unemployment claims numbers. State sales tax receipts during the quarter ending September 30 were up 1.7% over the same quarter last year and increased 2.3% during the second calendar quarter. This compares to -2.0% for the first quarter and -3.5% for the final quarter of 2001. Unit sales of cars and light trucks rose 2.9% in May and June this year.

Even with the recent improvements, the State is budgeting on the basis of a continued sluggish recovery. As the state has diversified away from the traditional manufacturing industries (textiles, apparel, furniture, and tobacco) to electronics and other technology-oriented companies, we have become more vulnerable to problems in the new sectors.

Key Economic Forecast Variables (% Change Unless Noted)

	Fiscal Year 2002 <u>Actual</u>	Fiscal Year 2003 <u>Budgeted</u>
<u>North Carolina</u>		
Total Employment	-1.1%	-1.4%
Manufacturing Employment	-7.1%	-4.5%
Unemployment Rate	6.3%	7.4%
Personal Income	1.3%	1.8%

REQUESTS FOR INFORMATION

This financial report is designed to provide our citizens, taxpayers, customers, investors, and creditors with a general overview of the State's finances and to demonstrate the State's accountability for the money it receives. If you have any questions about this report or need additional financial information, contact the North Carolina Office of the State Controller, Financial Reporting Section at (919) 981-5454.

The State's component units issue their own separately issued audited financial statements. These statements may be obtained by directly contacting the component unit. A list of component units and contact information is available in Note 1, beginning on page 64.